INVESTMENT COMPANY INSTITUTE

RESEARCH COMMENTARY

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Competition in the Mutual Fund Business

Key Points

- **The U.S. mutual fund business operates in a highly competitive financial services market.** The 600 organizations that offer mutual funds compete among themselves and with other investment services and products.
- **Three types of pressures stand out as drivers of mutual fund competition.** The 90 million fund shareholders' demand for investment performance and services at a competitive level of fees and expenses continually impacts mutual funds.
- **Mutual fund shareholders are heavily invested in lower-cost funds with above-average, long-term performance.** More than three-quarters of stock and bond fund assets are invested in funds charging below-average operational and management expenses; nearly two-thirds of stock and bond fund assets are held in funds with above-average, 10-year performance records.

A Large Number of Mutual Fund Sponsors Compete for Investors

The U.S. market for mutual funds is highly competitive and dynamic and provides strong market incentives that reward or discipline fund sponsors based on their ability to meet their shareholders' investment and service needs and demands.

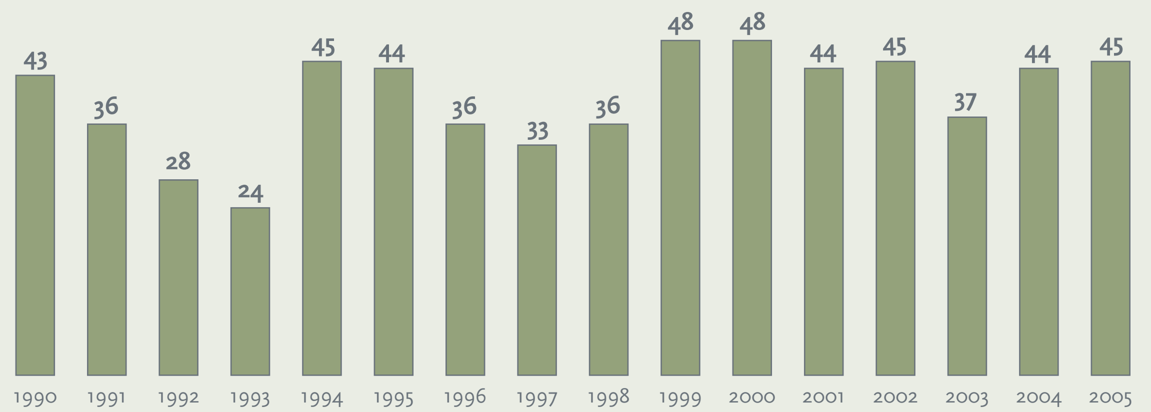
More than 600 fund organizations offer funds that manage investors' assets, and fund investors can redeem their shares in a fund at any time, requiring fund sponsors to continually compete with one another to retain and attract investors. In 2005, for example, shareholders redeemed about one-quarter of their stock and bond mutual fund assets and, in every year since 1990, between one-quarter and one-half of fund sponsors experienced net outflows from their long-term funds (Figure 1).

Brian Reid, ICI Chief Economist, prepared this report.

Figure 1

Many Fund Complexes Are in Net Outflow Each Year

Percent of Mutual Fund Complexes with Net Cash Outflows from Long-Term Funds, 1990–2005



source: Investment Company Institute

Mutual funds not only compete among themselves for investors, they also compete with other investment services and products. Mutual funds manage about 20 percent of household financial assets. Investors and their financial advisers can also choose to invest in bank deposits, insurance products, separately managed accounts, direct holdings of stocks and bonds, hedge funds, real estate investment trusts, exchange-traded funds, and other investment products.

The large number of fund sponsors and the dynamic nature of the financial services market have kept market concentration of the largest fund sponsors stable for the past 15 years. For example, in 1990, the 10 largest mutual fund sponsors managed 53 percent of mutual fund assets; in 2005, the 10 largest firms managed 48 percent of the assets (Figure 2). Competition and other market dynamics have also altered the rankings among fund companies, such that many funds once ranked among the largest firms no longer exist or have fallen in their assets-under-management ranking. Of the 10 largest mutual fund sponsors in 1990, five were not ranked among the top 10 in 2005.

Figure 2

Mutual Fund Market Concentration Has Remained Low and Stable

Share of Assets at Largest Mutual Fund Complexes, Selected Years

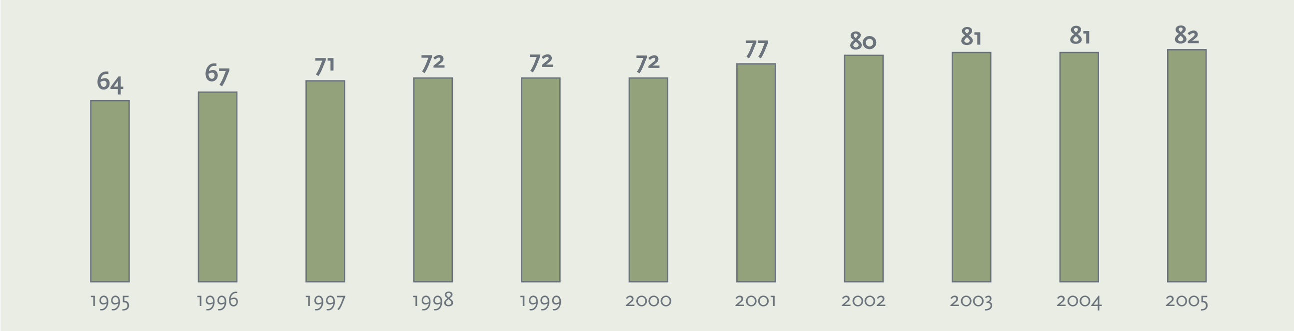
	1990	1995	2000	2003	2005
Top 5 complexes	34	34	32	33	37
Top 10 complexes	53	47	46	46	48
Top 25 complexes	75	70	74	72	71

source: Investment Company Institute

Figure 3

Investors Tend to Own Funds with Long Performance Records

Percent of Stock and Bond Fund Assets Invested in Funds That Have Operated for at Least 10 years, 1995–2005



source: Investment Company Institute

Shareholders Place Competitive Pressures on Funds

Approximately 90 million investors, with a wide range of financial objectives and service needs, currently own mutual fund shares. These shareholders can use a variety of resources to choose the funds that best meet their investment goals and service needs. For example, funds provide a large amount of information — available through disclosure documents, media sources, online search tools, and fund websites—that helps investors select funds.

Fund shareholders often receive additional assistance in processing this information when selecting funds. Nearly two-thirds of all fund shareholders invest in mutual funds through retirement plans at work, and employers sponsoring these plans rely on this information to choose the funds and other investments that they offer to their employees. Among shareholders who own funds outside of work retirement plans, 80 percent use financial advisers, who help investors identify the funds or other investments that best meet their financial goals.

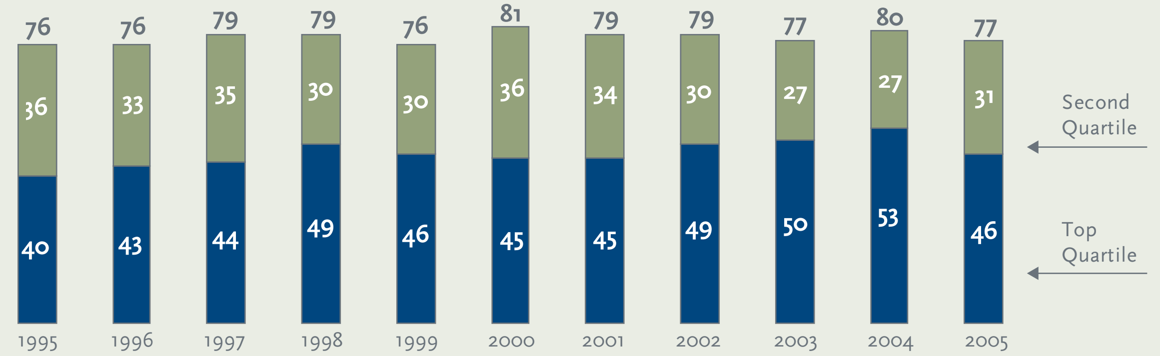
Competition, in general, drives firms to innovate and thereby differentiate themselves in the marketplace. This differentiation can take the form of fees, service, and other factors that allow funds to target particular groups or types of investors. Over time, however, shareholders reward funds that are best able to deliver performance and service at a competitive level of fees.

Pressure to Compete through Performance. Shareholder demand for performance is one of the most widely documented competitive forces. Numerous academic papers have demonstrated that the best performing funds receive most of the net new cash flow.[1] Moreover, mutual fund assets are concentrated in long-established funds with above-average performance histories.

Figure 4

Fund Shareholders are Heavily Invested in Funds with Best Long-Term Performance

Percent of Assets of Long-Tenured Stock and Bond Funds in Top Performing Funds, 1995-2005*



**percent of assets of stock and bond funds with 10-year performance history held in share classes whose performance is among the top half in their investment objective category*

sources: Investment Company Institute and CRSP University of Chicago, used with permission, all rights reserved (773.702.7467/www.crsp.com)

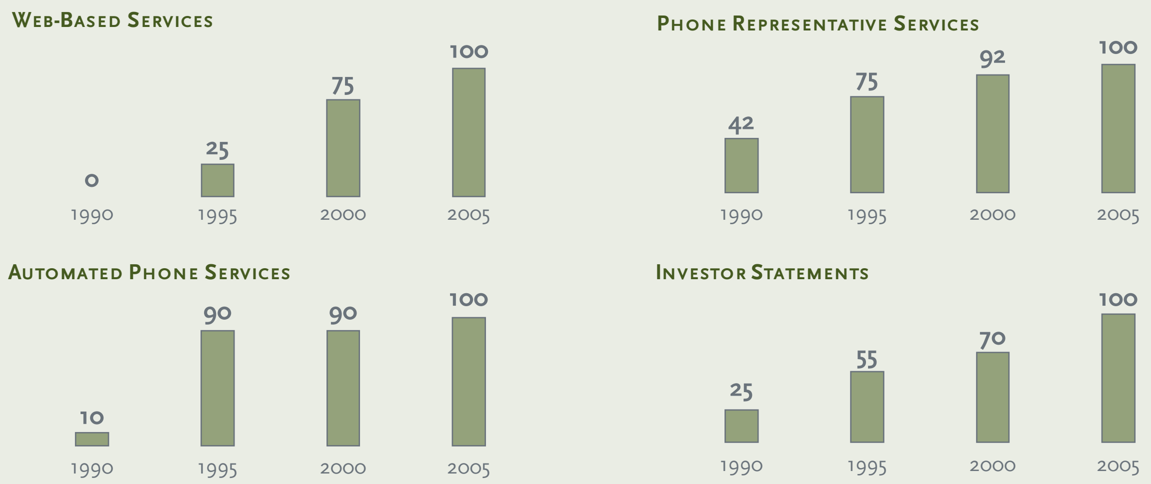
Investors, with the help of their financial advisers and retirement plan sponsors, appear to favor long-tenured funds. From one year to the next, investors have held roughly three-quarters of their stock and bond fund assets in funds that have operated for at least 10 years (Figure 3). Fund shareholders' tendency to invest in these funds is striking because during the past two decades there has been tremendous growth in the creation of new funds to meet the growing investor demand. In fact, only 10 to 20 percent of all stock and bond funds in any given year since the mid-1990s have been open for a decade or longer.

When shareholders choose among funds with long performance records, they favor those funds that have the best long-term performance. Those stock and bond mutual funds ranked among the top half of their peers, as measured by 10-year performance,[2] manage more than three-quarters of the assets held by funds with performance histories of 10 years or longer (Figure 4). Taking together investors' preference for long-tenured funds with above-average performance, investors held nearly two-thirds of *all* of their stock and bond fund assets in funds with above-average, 10-year performance records.

Figure 5

Mutual Funds Broaden Scope of Services

Percent of Services Available in 2005 That Were Offered in Previous Years, Selected Years



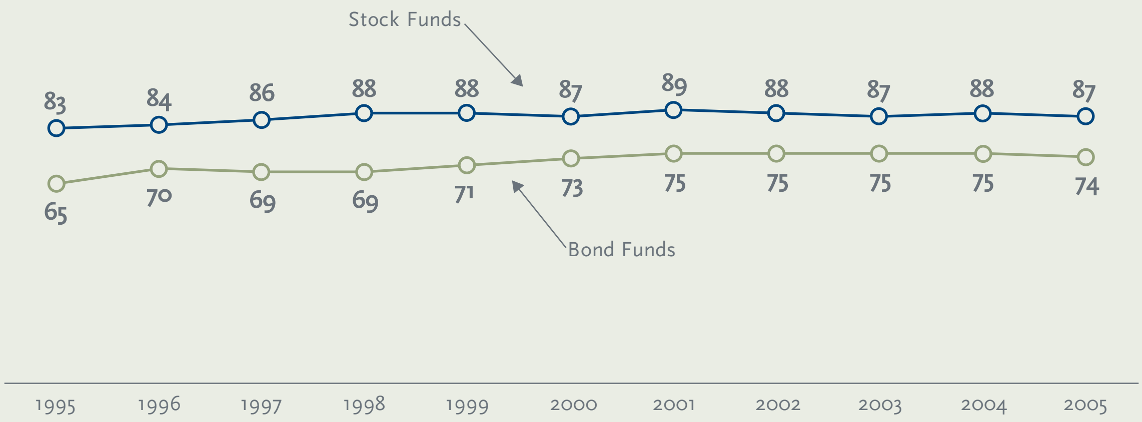
note: The percentages shown represent the scope of services available in the leading mutual fund companies at the indicated time period. The scope for each year is in relation to the services offered in 2005, which is shown as 100 percent.

source: DALBAR

Figure 6

Investors Hold Lower Cost Stock and Bond Funds

Percent of Stock and Bond Fund Assets Invested in Funds with Operating Expense Ratios Below the Median, 1995–2005



sources: Investment Company Institute, Lipper, and Value Line Publishing, Inc.

Pressure to Compete with Service Innovation. Shareholders also pay close attention to fund services. Mutual funds offer a broad range of services as competition drives them to innovate and offer new and better services. For example, fund organizations typically maintain elaborate websites that provide current and prospective investors with information about mutual funds and investing, and upgrade their websites with information and services not available 15 years ago (Figure 5).[3] Fund companies have also significantly expanded the scope of other shareholder services, including information provided on shareholder statements and via the telephone.

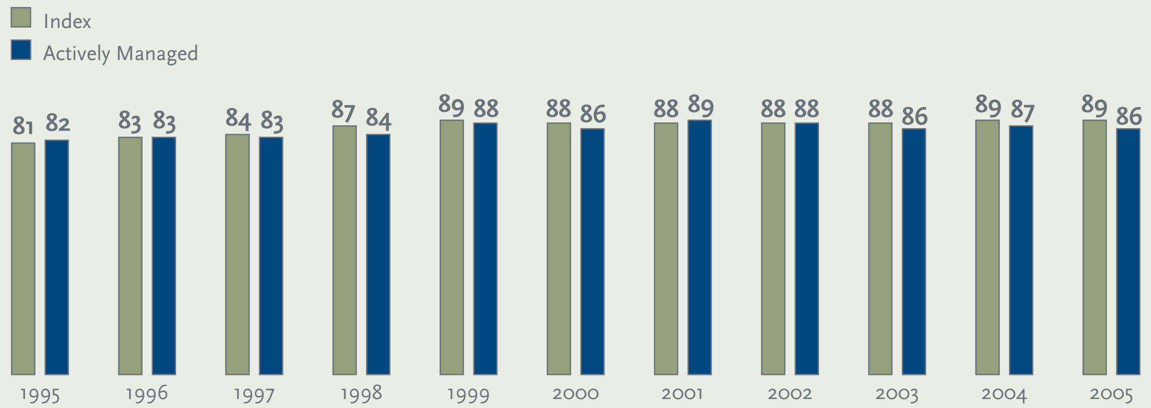
Other, more tailored services appeal to particular groups of investors. Walk-in offices in multiple locations serve shareholders that prefer the option of face-to-face contact with fund service personnel. Many shareholders use a financial adviser when buying funds, and fund organizations offer share classes designed for investors who choose to employ advisers. These share classes serve to bundle financial adviser services with the services that funds provide.

Another service that varies among funds is the size of the investor account that a fund will accommodate. Funds that offer low account minimums must hire more staff and devote more resources to service the additional shareholders than do similarly sized funds with fewer investors and larger account balances. Consequently, funds that make investing more accessible by offering low initial minimums often have higher expenses than funds that have larger average accounts.[4]

Figure 7

Investors Hold Lower Cost Index and Actively Managed Funds

Percent of Stock Fund Assets with Below Median Operating Expense Ratios, 1995–2005



source: Investment Company Institute

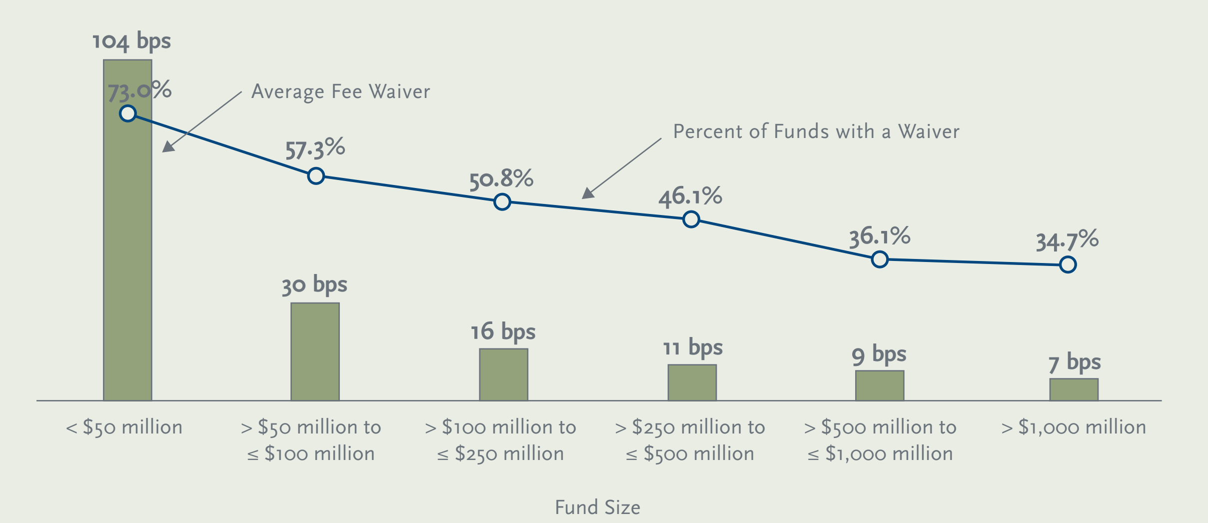
Pressure to Compete on Cost. Although shareholders purchase funds for performance and service, they also are heavily invested in lower-cost funds. Investors hold most of their stock and bond fund assets in funds charging below-average operational and management expenses (Figure 6). This trend is observable when examining investor ownership of both index and actively managed mutual funds (Figure 7).

The demand for lower-cost stock funds seems particularly notable in recent years. About 90 percent of the net "new cash" flowing into stock funds since 2003 went to funds with costs lower than the median fund, compared with 75 percent of the flows to funds below the median in the mid-1990s.

The use of fee waivers to attract and retain investors provides further evidence that funds compete on cost. Small funds tend to have higher operational costs, when measured as a percentage of assets, than larger funds. This largely occurs because funds often experience operational efficiencies as they grow in size, helping to keep costs down. Small funds' expenses typically do not reflect their full operational costs because many small funds waive a portion of their fees in order to compete with the larger funds (Figure 8). If competitive market forces were not at play, these small funds would not have to waive fees and could charge the level of fees necessary to operate the fund and provide a profit to the fund sponsor.

FIGURE 8

SMALL FUNDS OFTEN WAIVE FEES



note: Data are presented for equity funds.
source: Lipper; ICI calculations

CONCLUSION

Hundreds of fund sponsors compete aggressively for investors' business. No mutual fund sponsor has a guaranteed base of investors because mutual fund investors can move their assets at any time to another fund or a competing product. In this dynamic marketplace, fund sponsors must continually strive to deliver performance and service at a competitive level of fees to their shareholders. These forces, along with the widely available information about funds that investors and their financial advisers use to compare funds, provide a strong market discipline to organizations that sponsor funds.

Notes

[1] For example, see Diane Del Guercio and Paula Tkac, "Star Power: The Effect of Morningstar Ratings on Mutual Fund Flows," *Federal Reserve Bank of Atlanta Working Paper,* 2001–15, August 2001; Erik R. Sirri and Peter Tufano, "Costly Search and Mutual Fund Flows," *Journal of Finance*, 53, 1589–1622; and Judith Chevalier and Glenn Ellison, "Risk Taking by Mutual Funds as a Response to Incentives," *Journal of Political Economy*, 105, 1167–1200.

[2] Funds were ranked within their CRSP investment categories. The investment categories used to rank funds by performance were asset allocation, domestic equity, global equity, global fixed income, domestic tax-exempt fixed-income, and domestic taxable fixed-income.

[3] Many services that major fund companies now offer were not available in 1990. Investor statements now list holdings of outside funds, benchmarks, cost basis, portfolio summary, and personal returns, none of which were offered in 1990. Newer services now available through phone service representatives include balance information, ability to conduct exchanges and redemptions, make address changes, and make direct deposits and payments. Automated phone services now provide transaction history, balances, and the ability to conduct exchanges and redemptions and order tax forms and additional statements.

[4] For example, see Sean Collins, "Are S&P 500 Index Funds Commodities?" *Perspective,* Vol. 11, No. 3, August 2005 (www.ici.org/pdf/per11-03.pdf) for a discussion of how average account balances affect the expenses of S&P 500 index funds.

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